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Resetting the playing field for mid-market m&a.(mergers and acquisitions)(Panel Discussion)

A furious pace of middle-market dealmaking obscures some emerging developments in m&a, such as financing conservatism, increased activism by consolidating buyers, and newer forces that influence merger and acquisition pricing

Selective Financing - Although m&a financing in general remains plentiful, there are signs of tightening at the margin. Banks, in particular, are getting fussier about pricing multiples, opting for larger mid-market transactions as opposed to smaller deals, and preferring buyout groups or companies with proven track records. But lending competition remains fierce and non-bank credit sources are ready to plug any gaps.

Sale Drivers - Consolidation plays are absorbing an increasing number of private companies, even though owner retirements continue to be a strong force. Selling to an industry consolidator can be both a liquidity move and a strategic action for younger entrepreneurs who have a chance to stay on and help manage an expanded business. Intensive search programs by strategic consolidators also propel the deal flow.

Pricing Choices - To a large degree, mid-market sellers exercise considerable clout over the prices they will accept, which may be dependent on the purposes of the sale. For instance, entrepreneurs selling into a roll-up may trim their demands if they can get in on a subsequent IPO. Willing buyers are all over the price range, depending on their objectives, e.g., scale, a technology need, the target's earnings power.

Timing a Sale - Are entrepreneurs preparing earlier than their predecessors to sell their companies? Not really. But they are running tighter, more focused, more efficient businesses that are primed for sale at the right time.

Going Private - The ranks of middle-market private companies are

being swelled by the increasing number of small-cap public firms that are fed up with the vagaries of the stock market. Going private usually follows frustrating attempts to get analyst coverage and drum up interest among investors fixated on large-cap concerns.

Selective Financing

M&A: We've been hearing some static from the field that deal financing has been a little tougher to come by since the second half of 1998 What are your experiences?

Deutsch: As one business wise man once said, "There is no pancake so thin that it doesn't have two sides." I think we've seen both sides of that credit pancake. On the one hand, because of competition among senior lenders, mezzanine lenders, and others, we generally have seen as accommodating a credit market for middle-market merger transactions as in recent memory.

On the other hand, it might be said that banks are a little less willing to simply lend. I think that, at the margin, banks are concerning themselves with more than the lending business. For example, they're concerning themselves with things that relate to fee income, things that relate to markets, things that relate to their ability to refer opportunities to their in-house investment banking units. Also, in general, they are looking for larger transactions.
So, while banks may be accommodating in general, they are more accommodating to larger middle-market transactions than to smaller middle-market transactions. Articulated differently, they seem to be following their buyout clients up-market in terms of transaction size.

In the final analysis, with all of these ups and downs, corporate credit is still very, very cheap. The cost of intermediate-term credit (say 10-year debt) is approximately one-half to three-quarters of a point cheaper than it's been over the last three years, and certainly several hundred basis points cheaper than it was in the '80s and early '90s.

One recent transaction of ours that was financed by Sirrom Capital indicates that there are other, external factors affecting the bank credit market as well. One of them is that some of these lenders are themselves in transition and some are, in fact, going out of business. Sirrom, which was acquired by Finova in the middle of our transaction, had made a credit commitment to our client; they performed on that commitment. However, the situation reminds us that there are exogenous factors at work in the credit markets.

Novak: I think we've seen a little bit of a tightening, a little bit more caution on behalf of the banks. Multiples of EBIT and EBIT-DA are dropping a bit. I think it started with the stock market decline last year, and it has continued.

Part of the reason, I am told by senior lenders, is that 1998 was such a good year. Some senior lenders now can afford to be a little bit more selective, and that is what they have decided to do.

Blum: Bank attitudes toward lending are affected by consolidation in the banking industry itself. Keep in mind that, thanks to bank m&a deals, banks themselves are changing even faster than many of their lending customers. We regularly see lenders leave or enter the scene, and we also see new lending strategies driven by the recent pairings of banks with investment banks.

If there is any tightening, I see it at the low end. Large customers continue to offer banks the chance to broaden their array of capital and advisory services. Because banks have so much liquidity to recycle - much of it as loans - economies of scale may be pushing them up-market

But there is a referee, as it were, putting boundaries on how banks can lend: namely, institutional lenders, such as insurance companies, mutuals, and pensions. Through direct private placements of debt - often on friendly terms - even smaller borrowers have a vigorous alternative to their traditional bank lender.

Hurley: Traditional senior lenders are giving red-carpet treatment to the small-cap growth companies that have been feeling underappreciated by the public equity market. The deal lenders are bending over backwards to woo the financial sponsors that they view as exit-minded repeat borrowers. Two of our recent m&a and recap transactions involved raising $26 million and $32 million for our clients.
We have noticed a definite trend on the parts of both intermediaries and the borrowers to rely more on people who have delivered in the past rather than try to get a little bit better deal from someone who has just started pushing a product or says that they have made a commitment to the market.

In general, I would say that the financial sponsors are getting preferential treatment from non-bank lenders and the bank departments that have been set up to focus on financial sponsors. They are seen as portfolio opportunities with growing needs and as having owners who are more likely to be able to step up and support a company if it begins to get into trouble because there are ripple effects for them that do not exist for the one-off recap of a family-owned slow-grower in basic industry. We've had a big difference in the proposals coming from the likes of a Fleet Business Credit or Heller compared with First Union and Mellon on a recapitalization where you have a 50% owner buying out another 50% owner.

The overall process is also being streamlined considerably. We are now selecting senior lenders for clients based on their having already become comfortable with the documentation of the subordinated

lenders, so that you have a higher probability of closing. We think that a higher likelihood of closing is worth paying for.

Scharfstein: I think that there is a tendency for people to view the banking and financing market based on very large transactions. People perceive those transactions as tracking the market. But one of the things we are hearing here is that as we move toward the lower mid-market transactions, the financing situation very often operates somewhat differently.

We see some of that tightening in the lower mid market. But we also see increased creativity, ingenuity, and aggressiveness of non-bank lenders in approaching the m&a marketplace. Though the terms may change somewhat, I think that this aggressiveness may enhance the ability to get the deal done, based on that non-bank financing.

Hubert: We haven't seen too much of a tightening yet in the market. I would point out that there is a distinction with respect to the types of groups that are doing the deals. If it is a top-tier group that has committed relationships and has worked with its lenders for years, obviously they enjoy a little more flexibility with respect to the deals that they are trying to do. Some of the newer groups that are just getting established are having a more difficult time trying to pursue the more aggressive deals.

The only rollbacks that we have seen are transactions in which the buyer has been a little aggressive with the amount of equity that it is putting in. These are mainly cash flow transactions in which the sponsor is required to increase the amount of equity or be a little more creative in order to get the transaction completed.

Robertson: I wouldn't say that what we have seen is real credit tightening. I think it is a confluence of the factors that have been mentioned already. There is an abundance of deals, bank consolidation has reduced the number of people to process them, and they are just being more selective. I think that is probably why there appears to be somewhat of a credit-tightening situation.
In the $50 million range, there is certainly no shortage of interest, and we haven't sensed any cutbacks in their aggressiveness to pursue a deal in these situations.

Schmucker: The lower middle market's appetite for lending, particularly transactional lending, has remained healthy. Funds are available for acquisitions, leveraged recaps, and where there is need for growth of capital. The regional banking level is a more competitive market than what you see at the larger levels.

We have not really seen tightening but we think that the lenders are being more cautious. At the end of the day, however, we are getting good transactions done.

M&A: Has there been any perceptible change in rates, terms, or availability since the media reported that the Federal Reserve Board has a supposed "bias" toward raising interest rates?

Blum: Our capital markets, which increasingly function beyond the reach of the traditional tools of monetary policy, limit what Greenspan can do. He can jawbone rates up and warn of impending rises in the rates that he can regulate. But recently, thanks to the richness of the capital markets, the yield curve seems not to change as much when he speaks as it used to.

Non-Bank Opportunities

M&A: If the banks indeed are changing terms, prices, and capital availability and possibly toning down m&a lending is anyone seizing the opportunity? Who is filling the vacuum? And has the current stance been an impediment to getting deals done?

Robertson: I don't think there is any vacuum. And credit is not a factor in terms of not getting deals done. I think you are seeing that the people are getting deals done.

Let's break it down and talk specifically about the financial buyer for the moment. The buyers who are willing to dial in more equity or go a little bit longer on subordinated paper are the guys who are getting the deals done. But in terms of the banks and senior credit, it is pretty constant.

Deutsch: There is also a pretty good "back-up" system in the form of a much more mature, well-developed, and well-capitalized commercial finance community. Many are business units of banks themselves. For example, First Union now owns CoreStates, a significant portion of whose wholesale banking profits come from Congress Financial, and many other bank organizations, like PNC, are now actively engaged in both cash flows and asset-based lending.

Robertson: If you look at the money that has been raised by the financial buyer community, only one-eighth of it, according to one article, has been put to work.

Scharfstein: The vast majority of transactions that we work with are strategic in nature. Very few, if any, are so fragile that a small change in interest rates would kill the deal. The rate change may alter the deal slightly but it is not in all likelihood going to have a really significant effect on it.

I think the theme that I see is that if the Fed's actions do nothing more than raise rates and don't impact the overall economy in terms of its vibrancy, then it is going to have virtually no effect on the level of m&a activity. The issue obviously becomes what the downstream

effect of all of this is.
Sale Drivers

M&A: What are the primary reasons for selling a company, as we approach the end of the 20th Century? Do they involve traditional concerns, like exit to retirement, or do you see more deals being done because of emerging trends, such as industry consolidations or roll-ups and technology?

Deutsch: I don't think we can begin the conversation without discussing consolidations. There was an interesting poll in Institutional Investor a month or two ago in which 74% of the chief financial officers surveyed considered their industry to be consolidating. And 29% of those surveyed weren't sure if their firm would be the buyer or the seller! Clearly, consolidation prevails.

Novak: We've had a similar experience. We do a lot of work in the industrial distribution industry, an area with 12 to 15 different segments. Many privately held sellers that we have been dealing with are really viewing the sale not so much as an opportunity to cash out at a high price and retire but as a strategic transaction for going forward.

A recent survey said that industrial distributors who would consider an acquisition offer would consider it because it would allow them to provide more products or services to their customers, to lower costs, or to bring more management skills to the company. Many of the entrepreneurs and owners that we've dealt with plan to stay on. They view the sale as a strategic step in positioning their company. They plan to run the business and are more interested in having the resources to beat the competition or their arch-rival in the marketplace than they are worried about cashing out and retiring.

Hubert: A number of the deals that we do really come from a defensive posture. There are several motivations. The incredible creation of the roll-up has changed the dynamics of virtually every industry. A result of roll-ups is that a lot of smaller, privately held companies that are now independent are being forced to invest substantially in technology and infrastructure in order to compete. This is in response to pressure by their customers to deliver better services at lower prices.

I think that another major driver is that deal prices are still very, very strong. All of these guys have heard about their friends and competitors who have walked away with big deals, and I think they see that it's a great time to sell and put some money in their pocket. More importantly, they can get into bed with somebody who is going to allow them to grow the business, be at the forefront of change, and make sure that the company is really in a position to lead the industry as opposed to following it.

Blum: The selling motivations of privately owned independent sellers

differ from those of divestors. Of course, both groups feed deal flow into the middle market. Both groups share the influences we have already discussed, such as high multiples in the deals marketplace. The speed with which various sectors now consolidate - let's be direct here - obviously also creates a fear factor. Both private owners and divestors often sell because they otherwise worry that competitors will outflank and/or outspend them.

But there are differences between the two groups. Divestors are often driven - in their quest to focus on core segments - to sell non-core businesses. Throughout the 1990s the markets have refused to recognize non-core values. With the recent high stock market P/E multiples, sexy segments often get undervalued and must be sold.

Private owners, on the other hand, continue to sell for reasons that wouldn't affect the divestor group - old age, burnout, lack of succession, for example.

Novak: One thing that we've seen on the privately held business side, in addition to the strategic reason that they want to sell to be better able to compete, is the fact that we are finding people selling at a younger age. We are finding people not waiting until they are 60 or 65 or 70 to sell. We are dealing with people who are 50 to 55 and are saying, "I want to take my money off the table. I know I will have to stay and run the business or help for a few years, but then I want to go off and do what I want to do."

Schmucker: We are seeing the traditional sale for retirement. We also see underperforming situations where the family management team is saying that to get to the next level it really needs to sell the business or bring in outside capital that can also bring in management talent. A couple of things have happened with roll-ups. One is that pricing has gone up. The second is that they tend to be in service-oriented sectors of the economy that are highly fragmented.

As a result, you now can be opportunistic at the age of 50 or 55 and exit. You might be a little more deal savvy as compared with someone who is holding onto that business into their 60s and 70s. But the other thing is that these competitors recognize that if you don't sell, you almost need to become an acquirer. That is something that certain clients of ours just aren't prepared to do and don't have the management talent to do.

Hurley: More than anything else the increase in sale activity has been demand-driven. Public companies needing to deliver more growth faster than ever before and private equity buyers allowing the auction process to apply for even small middle-market companies are pulling sellers into the market. The trigger has been the incoming telephone call. The savvy entrepreneur, who may be 29 or 59, takes a long look in the mirror and says, "We've had several years of a good run here and if somebody will pay me a premium multiple on my best year ever, I am not going to turn a

cold shoulder to a gift horse. Maybe we ought to talk about it."

Scharfstein: We have seen that management of the entrepreneurial company today has become more responsive. It has to move faster. It can't do business the way that it did 10 or 20 years ago. As a result, you find business owners who are more responsive to the unsolicited phone call, the unsolicited letter, or the roll-up going on in their industry. They are not married to their businesses.
We do annual surveys of privately held businesses to try to understand some of the trends that are impacting our market. And the most staggering statistic that I've seen is the younger age of business sellers. Ten years ago, the average age of business sellers in our survey was in their 60s or 70s. They were selling because there were no kids going into the business, no one was there to take it over, and this was their last hurrah to sell the business. The average age has dropped 15 to 20 years for a typical business seller today. Our survey found that the seller is more likely to be in his 40s or 50s.

That is just a staggering statistic as to how much younger these sellers are getting. It is also telling us that they must be selling for reasons that are different than the traditional ones.

Robertson: All of these point to the extraordinary market we have. But we have found that over the years, the volume of transactions is directly related to the buyer's ability to meet the seller's expectations. We had a long run of high equity prices, attractive interest rates, and extraordinary availability of money in the hands of buyers. So, the younger sellers and people like that wouldn't be calling us up if they didn't know that there is an abundance of money out there. I think that the principal reason that we are seeing such a long run of this activity is, again, due to the terrific state of the debt and equity markets that allow all of these deals to go on.

Deutsch: There's also another issue at work here that, perhaps, wasn't at work a few years ago. There is probably as great a disparity today between the stated motive and the real motive of corporate sellers as there's ever been.

In years past, there was much more motivation by the private seller to liquefy his ownership stake in the business that he and his wife (or vice versa!) had built over 20 to 30 years. Today, there's still that stated objective, but the beneath-the-surface objective may very well be to avoid battle with new competition in a totally reshaped industry - to avoid greater-than-ever investment required in MIS, operations, and new personnel, etc.

Novak: I think there is another signal, as well. We've had such a strong deals market for 20 years in the 80s and most of the 90s that the buying and selling of businesses has become somewhat institutionalized.

There was a time when you bought or grew a business and kept it until you were ready to retire. Now people often buy or get into a business with the idea that it can be sold to a strategic acquirer or an LBO firm in three years, five years, or 10 years. If the opportunity is there, they will flip it with little remorse and go on and find something else to do.

Hurley: At the older businesses, you are seeing owners who are saying, "I've made more money with what I kept out of the business over the last five years than with what I've seen in appreciation in the value of the business. So, why not sell and put it somewhere else?" Owners are acting more like investors. Cycle time has been shortened dramatically, Owners are better informed and influenced more and more by the impact of their business decisions on enterprise value and transferability.

Pricing Choices

M&A: Is there any correlation between the seller's motives and the pricing multiples?

Blum: I can think of factors that would drive lower-priced deals rather than higher-priced deals. On the low end, you often see companies with succession problems, or fear of larger competitors. Such companies may also have that wonderful term we all use: "warts." You also see such factors among divestors.

At the high end of the middle market, sellers may have most of the ingredients to go public, such as a growth track record or proprietary technology Or, they may be undergoing what I call "the tail becomes the dog syndrome." For example, one of KPMG's clients provides services to the trucking industry This includes a logistics operation, which used to be minor - the "tail." It is now "the dog," so to speak, and it will sell at a very attractive multiple.

Hubert: We see a lot of sellers who actually view their sale as an intermediate stage in their growth. They are looking to put a little money into their pocket and get into bed with a strong acquirer. In some situations the acquirer is a consolidator. Ideally, it is a roll-up that has not yet gone public. But they are really looking to the back end, whether that is through an IPO or through an additional sale at some point when they have additional bulk.

But clearly, they have become much more educated about the process and more deliberate about not only preparing for it but also for setting their expectations going forward. So, they are willing to sacrifice some of the multiple up front for their belief that the back end is going to be that much greater.

Robertson: We find that with a lot of the smaller, privately held companies the owners just have a number in mind. They think their business is worth X dollars. And you get into a market like this and they say maybe X dollars are available. So, they call you up and

bingo, that is what leads to a transaction.

Novak: Selling itself has become a strategic transaction for a lot of people. They look at the opportunity to get a strong partner and maybe to do a consolidation or to help consolidate an industry, When they had all of their own money on the table, they weren't willing to take the risk. Now they can sell to a strong financial partner, take most of their money off the table, leave some in, and continue to ride it on the upside with the use of somebody else's money.

Deutsch: Back to the notion of stated versus unstated objectives. Many of our clients begin with the comment that they don't have to sell; they are suggesting that they want to achieve a full price - not what they consider to be a desperation price. That inevitably leads to the "let's simply speak to one prospective acquirer at a time" scenario.

The problem is, to use a skiing analogy, that if you lean too far back, you lose control. If you lean forward and get your weight over your skis, you control where you're going. If you control a transaction or stimulate a more competitive transaction, you'll achieve better results. So, the ostensible motive - that we don't necessarily have to sell - really must be addressed with the client to maximize its own value.

Schmucker: Our experience has been that when a sale is for retirement, you tend to have a client who makes it more difficult to run a competitive process. There are concerns about leaks and secrecy and confidentiality and how much information we should present. A more sophisticated, younger seller understands that if you run the process right and let the intermediaries do their work, you should be able to maximize value.

Deutsch: We often tell our clients that m&a involves three sometimes-inconsistent objectives: speed, confidentiality, and value. We suggest that they identify the two that are most important to them.

M&A: The flip side of pricing is the buyer's motivation and its plans for the target, such as strategic add-on, one-off LBO buy, or early, middle, or late stages of a roll-up. What are some of the rough multiples associated with any of these various niches?

Hurley: If you are in a basic manufacturing business you are not likely to get more than six to seven times your trailing "adjusted" operating cash flow for a debt-free business. If you are talking to a financial buyer or operating company, they are looking at returns. If you are talking to a public strategic buyer, we have found that they are much more interested in earnings per share. And you can allow your multiples to float up if you have high growth and are not capital-intensive.

We had a closing last week at 12 times operating income for someone that was willing to take stock in a newly public company. Everything was driven around the EPS and nobody talked about multiples of cash flow, providing enough return to pay down debt, or anything else, because the seller was taking stock.

Hubert: We had a recent deal in which our client just signed a letter of intent where the buyer is a public company that absolutely had to have my client's technology and access to its customer database. We put together a deal that was initially priced at 10 times pretax cash flow. It was a mixture of cash, stock options, and convertible debentures which the buyer believes are going to be worth anywhere from 20 to 40 times my client's current cash flows in three to five years.

Deutsch: Value is a function of many things. It's a function of industry, a function of our client's relative attractiveness within its industry, and a function of their size. We are definitely seeing stratified levels of value where, for example, the sub-$50 million in sales company can't pierce the 6.5 times EBIT-DA ceiling, while companies that are nearly identical, but two or three times as large, are operating in a realm where 7.5 to eight times EBIT-DA might be the norm.

Hubert: Our deal was actually a defensive deal. The buyer is a small-cap company with a market cap of about $120 million. So, this was a substantial deal for the company. The buyer recognized that it needed to make a fundamental change in its operating philosophy and it believes that my client is going to bring the technology and the access to do it. So, the buyer is really making a large bet on that strategy.

Technology Kicker

M&A: How important is the seller's technology, as an added asset or an added advantage, in setting a price, given the projections for a great appreciation in value?

Hubert: Their technology is going to allow the buyer to access what it thinks is going to be more of an Internet-type of channel for its business relationships that are transaction-based. Again, it comes down to a function of earnings per share, which the company thinks is going to be very substantial. So, it wants to make that bet.

Hurley: More and more CEOs are willing to pay whatever they have to for technology that they believe is essential. It may be a big gamble, but the alternative is just as risky.

Scharfstein: We've seen a consistent movement toward defensive acquisitions. With public-market stock prices at the current record levels, an acquirer's motivation may not be based on raising his stock price but rather on protecting the valuations in the market today. We have seen a number of transactions in which strategic

buyers have paid extraordinary multiples of earnings that were highly justifiable from their internal calculations.

The cost or the risk of not "pulling the trigger" on an acquisition was perceived as greater than the risk of doing it. This is especially true in highly strategic, surgical types of acquisitions in which the transaction size is not large in terms of dollars but the deal is very significant in terms of the strategic value to the buyer.

Hubert: On the other hand, a lot of the consolidators who are now public have seen their stock currency take a hit over the last 12 months and as a result have been very, very disciplined about the types of multiples they will pay, especially if the acquisition is not an integral part of their plan. We see a number of transactions in which the strategic buyer in a consolidation play doesn't want to pay more than a multiple of five or six.

Novak: Sellers have to be careful as well. If they don't catch that consolidation wave at the right time, they may find that consolidators or strategic acquirers already have filled the need in terms of geography, product, or service. The deal on the table today may not be on the table a year or two later.

We work on behalf of large corporate clients as well. If your number one target turns you down, you go to number two on the list. He sells and fills your need. The number one guy might come back to us two years later, and we're not really interested anymore. So, timing makes a big difference.

Schmucker: One thing about our clients who are executing consolidation strategies is that they are still able to go out and find the seller who is willing to sell at four times cash flow. I think that if you are disciplined as a buyer you can be successful at buying cheaper.

Timing a Sale

M&A: Do you find these mid-market companies preparing earlier and more systematically for either a sale or an acquisition, including the longer-range possibility that today's acquirer may be bulking up for a sale down the road?

Blum: Because things are happening so quickly these days, I don't see as much preparation as you would expect. This is particularly true at the low end. However, I also have seen better preparation on the estate planning side.

Bear in mind that private sellers face three potential tax bites: corporate, individual, and estate. At the estate level, more is being done now to plan. But I don't see more being done to prepare the company.

Deutsch: It seems to me that more transactions have begotten more discussions which have begotten more preparation which has begotten more transactions. This preparation is being done not only by our clients but also by our clients' accountants and legal counsel who are often quite deal savvy. Today, all of the Big Five accounting firms have well-developed "transaction support groups."

I think that the clients themselves are simply more m&a savvy and are concerning themselves more with what they have to do, what they have to look like, what their financials should look like, and what their management team has to look like to prepare for an acquisition or sale.

Scharfstein: Many business owners and entrepreneurs are focused on what they have to do to run their business well. That means building the right management team, building the right information systems, developing reporting systems, and doing all the things that actually help our efforts in selling a business. They are not doing these things because they want to sell; they are doing them because that is the right way to run their business.

The fact that many of these entrepreneurs are receiving letters in the mail from consolidators and unsolicited offers can lead to situations where those who are not operating their business in this manner are not necessarily prepared to respond to potential purchasers. We are spending a lot of time advising business owners who were unprepared to sell, but guess what? When the right dollars are on the table now, you can't afford to wait. So, you've got to do what you've got to do and hope that buyers are savvy enough to understand what the business really earns. That is a very basic issue.

Robertson: We are about to enter the market to sell two companies. Prior to this year, we helped both of them execute acquisition programs with the stated purpose of building the companies up to sell them.

The one common characteristic that they both had was a control individual. Each had one control stockholder who was comfortable with his control position and knew he had to build it up because he was going to get a higher value in the ultimate sale.

Novak: What we have seen is not necessarily preparing sooner but preparing smarter for the sale. Because they recognize that cost savings drive a lot of the industry consolidations, middle-market sellers are becoming much smarter and much less emotional about pointing out the cost saving opportunities - the opportunities for acquirers to eliminate departments, people, and so forth.
Years ago that was a very sensitive and emotional issue for a privately owned seller. Today, they understand that that may happen anyway and may be a driver in their industry. So, they figure they might as well do it up front, make the adjustments, put it

on the table, and get a higher price as a result.

The End Game

M&A: More mid-market companies, both private and low-cap, are acquiring today rather than pushing their strategies internally, like through bricks-and-mortar expansion or R&D or something like that. What are their purposes? Going public, staying private but being more competitive, becoming a consolidator?

Scharfstein: We see people making very rational business decisions as to why they should be considering acquisitions. Many of those are defensive in nature. We are representing an electronics distributor who felt that his suppliers wanted to deal with companies that were nationwide as opposed to regional. As a result, the only way they could stay in business and keep their franchises was to either grow through acquisition or sell.

The flip side of that situation is demonstrated by a packaging company that we just sold. Major customers told the owner of the company that they would no longer buy from single-plant sources anymore. So, either the company had to become global and fit into its customers' Year 2000 purchasing pattern or it had to sell to someone who had that kind of plan.

Many of these good business decisions are driving business owners to consider purchasing businesses. But once you do such an acquisition and you stay in business, what do you do for an encore? Often, a growth strategy is a prelude to an exit strategy.

Deutsch: For the last several years, many astute acquirers have been looking to capitalize on an impossible-to-ignore arbitrage between public- and private-market values. Buyers first achieved high private-market values through growth in scale and then accessed even higher values through public equity offerings.

Over the last six months, it appears that at least as many of those same acquirers have been planning for possible recaps or private sales as IPOs. They can recap into an accommodating credit market or complete a private sale to a consolidating industry competitor and, often, achieve better results than through an IPO.

Hurley: A common characteristic among our clients is the willingness to diversify their holdings to spread the risk and multiply their opportunities. We have one client who sold his business and is now funding three companies that are growing through acquisitions. None of the presidents of those companies would be as aggressive about acquisitions if they didn't have this investor driving them.

A large number of the middle-market companies that are out making acquisitions today are being pushed to do so by private equity

investors and strategic partners who are interested in high growth through whatever necessary means. It is characteristic of the founder to be opportunistic and to pounce on something that becomes available at an attractive price. But the investor mentality is driving the company to build value by seeking out acquisitions, pushing hard to realize value so that they can recycle it and do it again and again.
Blum: I don't really think that the number of middle-market purchases has risen explosively. There has been some increase along the entire deal-size spectrum, but most of the growth has been at the high end.

Raised Horizons

M&A: Are any of the mid-market companies that you service interested in going overseas? And under what circumstances would this happen?

Hubert: Many companies have their hands full with domestic opportunities and are trying to sort themselves out in some strategic fashion. At the lower end of the middle market, a lot of these companies don't have the management depth to manage and facilitate an overseas acquisition. So, if they need to have an international presence, usually their first option would be a joint venture or setting up an overseas sales organization just to get their toes wet.

Blum: At the high end of the middle market there has been some increase in cross-border activity. Purchasers abroad often follow customers overseas and/or seek access to cheap labor abroad. For the last six months, acquirers have tended to focus on the safer parts of the world.

KPMG currently is advising a metals company that is reaching cross-border to create a transatlantic alliance. It is doing so because many of its customers have gone global, so it will have to be in more places than it is now.

Deutsch: As a general rule, the smaller the client the more likely the transaction will be incoming rather than outgoing. But there is a change in that smaller-than-ever companies are themselves considering acquisitions overseas.

They realize that they are in global industries, that their customers are demanding lower and lower prices, and that they have to search the world to source products. They realize that they have international customers. These smaller companies are considering not only foreign acquisitions but also joint ventures with foreign partners.

Scharfstein: Although this is a two-way street, clearly the vast

majority of the traffic is heading in the direction of the U.S. as opposed to overseas. We still see that mid-market U.S. companies are extraordinarily attractive to foreign purchasers, and that trend is not slowing. It is reaching down to a lower and lower size range of companies.

Novak: In Europe, middle-market companies that used to be national in focus now are becoming regional and continental in focus. To some degree, our experience in the U.S. is the same. Companies that may have been regional now are national in focus, and this is going lower into the middle market. Beyond that, they are looking north to Canada and south to Mexico or even further down in Latin America.

Deutsch: Industry matters. In industries where you have globalization, there is more consideration of cross-border m&a. In service industries, for example, there is less global consolidation; however, there are thousands of potential targets right here in the U.S.

Schmucker: We've had clients who have been frustrated in trying to penetrate Europe from this side of the Atlantic. They finally say that the only way that they are going to eventually do this successfully is by having a physical presence over there.

M&A: Is the Asian economic problem causing any problems in selling companies with Asian connections, such as firms that export or source materials or finished goods from there?

Blum: The situation in Asia has to be bifurcated. In longstanding Asian democracies, principally Korea and Japan, there is clearly a buying opportunity. People are already going in. KPMG's Dealwatch m&a data base shows that in the last six months, there have been several times as many deal announcements into Korea and Japan as there were a year or two ago.

I made a dozen trips across the Pacific since 1998. The beginning of that period was vastly different than it is today. Recently, m&a advisers like us have been there continually. The companies they advise are in the marketplace for large and mid-sized Korean and Japanese targets. There is clearly a perceived value opportunity there.

Deutsch: We work with quite a few consumer-related companies, many of which sell their products to Asian consumers as well as domestic customers. Many have experienced a blip in demand for their products and, consequently, a blip in their earnings. Clearly, there's been a change in the valuation of those enterprises.

The question is, what is that new value and how do you address it? We find that we simply can't get as full value as perhaps we'd like, even given the promise of substantially greater sales overseas. That's where transaction structure comes in to play. That's where

earn-outs, and structure in general, are that much more important.

Hubert: We represented a selling company in the charter tour business that sourced 50% of its originations from Japan and Korea. The deal was about two or three weeks away from closing when the buyer halted it for about a month and then came back requesting a 20% to 30% discount with the chance to make up the difference in an earn-out. My client had more faith in the market and his prospects and decided to hold off on a sale for two or three years.

Going Private

M&A: A lot of small-to-mid-cap companies are asking consultants to review strategic alternatives, which often telegraphs that they are looking for offers. Why are so many companies doing that now? Are they thinking that small-cap stocks don't have much of a future and that this is the time to get out?

Robertson: We've been working increasingly with smaller public companies, and their problem is that they can't get research coverage from the Street. With the consolidations of firms on the Street and the migration of the best analytical minds to the buy side, the number of analysts covering small companies today is down, and they are under pressure to produce. So, their focus is on larger-cap companies, in which institutional liquidity and trading activity are not an issue.

Schmucker: When I talk to my institutional salespeople, they tell me that only when you reach a market cap of $1.5 billion are you no longer a small-cap stock. That explains why it is difficult to maintain research coverage over a period of time.

In the past, you could have gone public with a $100 million-or-less market cap and you would have been okay as long as you made your numbers. But once you stumbled, the institutional holders would have sold, stock prices would have gotten driven down, and you quickly would have became an orphan stock. Once you are an orphan stock you don't have the float or the market cap to attract liquidity and you are stuck because you can't raise the capital that you need. Many of these companies have said that they need capital, and being public is not something that lets them access the capital that they need.

Deutsch: There are a couple of quite different motivations for going private. Those that find themselves in a field with larger-cap companies and that are not well covered by much research are not that interesting to institutions. At the same time, they may not be sexy or glamorous enough to be interesting to individuals. Therefore, their stocks are undervalued and they may consider going private.

There are also those, like St. John Knits, that are going private as a proactive business strategy. St. John management has told the

financial press that the company does not wish to remain on the public earnings treadmill, where they must grow at, for example, 25% a year. They would rather grow at, say, 10% a year and become better capitalized . . . but not do it in public view.

Blum: I think that growth is a crucial factor. If you look at stock-market performance over the last three or four years, investors and purchasers have come to expect growth and value. They, therefore, also expect growth in the companies in which they invest. Growth rates that might satisfy most people in most time periods don't appeal to public investors today.

Scharfstein: If those companies are too small, too thinly traded, or have a low float, there is a very significant cost to being public. And frankly, if they have significant shareholdings, they would likely save on those costs if they were private.

In addition, it's a huge distraction. We have represented a small, marginally performing public entity whose management says that it spends 40% of its time answering calls from small, irate stockholders who are wondering how come there is little activity, there is no liquidity, and there is no movement in the stock price. If management could spend its time running the company as opposed to managing a public entity, the company would be far better off.

Schmucker: The Holy Grail was to go public, and even if you couldn't get any liquidity on that event, the owner was going to cash in within 24 to 36 months. That hasn't happened. Going private is now the way to really achieve that liquidity.

Hurley: I think the retention of financial advisers is mostly driven by the boards of directors and fiduciaries who want to make sure that management is being tested, or maybe is ready to be replaced. Most of the boards are confirming that there was a reason for going public. I think the independent directors are also concluding that management needs to set its sights a little higher.

Winning Bidders

M&A: We have noted that there is a lot of competition for middle-market targets. What types of buyers are the big winners in these contests?

Blum: It's hard to generalize, but for growth companies and for companies that are independent, privately held firms with good track records, U.S. strategic acquirers are the advantaged buyers right now. Strategic acquirers often have equity as an acquisition currency, which has special tax value to the owners of privately held businesses.

Targets with flatter growth histories and divestitures are the categories where financial players are regaining market share. But in

both categories, I don't see foreign bidders for middle-market targets as having special advantages.

Hubert: We still see U.S. strategic buyers carrying the day in the majority of the deals. They are in the best position to take advantage of the synergies and there is compatibility of culture. We do about 60% of our transactions with them. But there is a foreign component involved, and we probably do about 10% of our deals with foreign strategic purchasers. The balance of our deals, about 30%, are done with the financial groups.

A lot of the time, the winner is a choice specifically made by the owner of the company We just closed a deal in which the owner took substantially less than he could have received if he had gone with a strategic purchaser. He did it because he wanted to make sure that his management team would stick around. They are going to get an ownership stake in the business going forward, and the culture of his business is going to continue. This was one of my client's most important considerations.

Scharfstein: We see the principal losers in this battle as the financial buyers, because they can be outbid by a strategic buyer when there is a bidding process. Sometimes that strategic player is domestic, sometimes it is foreign.

The biggest advantage that the domestic players have is a cultural one. They understand how to negotiate and they understand how to move the process forward. Sellers often feel more comfortable with domestic buyers, but foreign buyers remain a real force in this arena.

Deutsch: The beauty of those businesses is in the eye of the beholder. In more cases than not, we've conducted sell-side processes that have resulted in an array of options for our client. At one end there is an all-cash proposal, perhaps from a strategic buyer. At the other end are essentially various versions of recapitalizations or continued investment on the part of the seller. We've also been surprised by changes in our clients' preferences mid-stream. Our clients may have initially favored an all-cash sale to a strategic buyer. Then, after getting to know more about the process, how the newly capitalized company might work, and what the newly capitalized equity might be worth, many have chosen to retain more substantial equity stakes in their "sold" companies - taking less cash today for more cash tomorrow. It is not so much a matter of who the winning bidder is as how those bids are viewed by our client. An important part of our job is helping them evaluate the differences among these proposals.

Novak: I will concur that we see the U.S. strategic buyer leading the charge. The people who are really at a disadvantage are financial buyers without a strategy, without a platform, or without a portfolio

that focuses on particular industry segments.

In many cases, "financial buyers" are simply privately held strategic buyers anyway, except that they are backed by financiers and LBO people. But the funds that are unfocused and just looking for a "good deal" somewhere usually end up in a disadvantaged position.

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